Nos. 2297-2298-A

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

No. 2297

UNITED STATES OF AMERICA,

Appellant,

vs.

CALIFORNIA PORTLAND CEMENT COMPANY, a corporation, Successor-in-Interest to ARIZONA PORTLAND CEMENT COMPANY, a corporation,

Appellee.

No. 2297-A

CALIFORNIA PORTLAND CEMENT COMPANY, a corporation, Successor-in-Interest to ARIZONA PORTLAND CEMENT COMPANY, a corporation,

Cross-Appellee,

vs.

UNITED STATES OF AMERICA,

Cross-Appellant.

No. 2298

UNITED STATES OF AMERICA,

Appellant,

vs.

CALIFORNIA PORTLAND CEMENT COMPANY,

Appellee.

No. 2298-A

CALIFORNIA PORTLAND CEMENT COMPANY,

Cross-Appellant,

vs.

UNITED STATES OF AMERICA,

Cross-Appellee.

Opening Brief for California Portland Cement Company.

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Nos. 22397-22398A

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

No. 22397

UNITED STATES OF AMERICA,

Appellant,

vs.

CALIFORNIA PORTLAND CEMENT COMPANY, a corporation, Successor-in-Interest to ARIZONA PORTLAND CEMENT COMPANY, a corporation,

Appellee.

No. 22397-A

CALIFORNIA PORTLAND CEMENT COMPANY, a corporation, Successor-in-Interest to ARIZONA PORTLAND CEMENT COMPANY, a corporation,

Cross-Appellee,

vs.

UNITED STATES OF AMERICA,

Cross-Appellant.

No. 22398

UNITED STATES OF AMERICA,

Appellant,

vs.

CALIFORNIA PORTLAND CEMENT COMPANY,

Appellee.

No. 22398-A

CALIFORNIA PORTLAND CEMENT COMPANY,

Cross-Appellant,

vs.

UNITED STATES OF AMERICA,

Cross-Appellee.

Opening Brief for California Portland Cement Company.

Jurisdiction.

These consolidated civil actions for refund of Federal income and excess profits taxes were duly commenced in the District Court for the Central District of California, under Sections 1346(a)(1) and 1402(a)(1) of Title 28 of the United States Code. The judgments of the District Court became final on July 31, 1967.[1] The Government filed its appeal on September 28, 1967,[2] and California Portland cross-appealed on October 6, 1967.[3] The jurisdiction of this Court rests upon Section 1291 of Title 28 of the United States Code.

Statutes and Regulations Involved.

The pertinent provisions of the statutes and Treasury Regulations involved are reproduced in Appendix A.

Statement of the Case.

These consolidated cases[4] involve the claims of California Portland Cement Company ("California Portland"), individually and as successor-in-interest to its former wholly-owned subsidiary, Arizona Portland Cement Company ("the Arizona Company"), for refund of a portion of the Federal income and excess profits taxes paid to the Government for the taxable years 1953-59.[5] The basic issue is the proper compu-

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[1]No. 22397, I-R. 162; No. 22398, I-R. 237.

[2]No. 22397, I-R. 163; No. 22398, I-R. 238.

[3]No. 22397, I-R. 165; No. 22398, I-R. 240.

[4]By Order of this Court entered January 11, 1968, the within cases were consolidated for purposes of briefing, argument, and decision.

[5]No. 22398 involves returns filed by California Portland with respect to its Colton Quarry and its Mojave Quarry (commencing in the taxable year ended April 30, 1956) for the taxable years ended April 30, 1953 through April 30, 1959, inclusive. [No. 22398, I-R. 177-78] No. 22397 involves returns filed by the Arizona Company with respect to its Rillito Quarry for the taxable years ended April 30, 1953 through April 30, 1957, inclusive. [No. 22397, I-R. 121]

tation of the Federal income tax percentage depletion allowance with respect to calcium carbonate rock extracted from the taxpayers' limestone quarries and processed into Portland cement.

During the period concerned, calcium carbonate rock was extracted by California Portland from its quarries located at Colton and Mojave, California, and by the Arizona Company from its quarry located at Rillito, Arizona, and processed by said companies into finished cement (Portland and allied types.)[6] The calcium carbonate rock at all the quarries had substantially the same physical, chemical and mineral properties, and was processed into the same product of finished cement by application of the same processes at each cement plant as follows: quarrying, crushing, raw grinding together with additives, storage of the resultant kiln-feed in silos, burning and sintering in rotary kilns to produce cement clinker, finish grinding of the cement clinker after the addition of gypsum and sometimes other additives, and storage of the resultant finished bulk cement in silos.[7] A portion of the finished cement was later placed in sacks, and all of such cement, both in bulk and in sacks, was loaded for shipment.[8]

In an action captioned *California Portland Cement Co. v. R. A. Riddell, District Director of Internal Revenue* (No. 138-58 W.M., Civil, decided February 16, 1965 and herein called "the 1951-52 Case"),[9] the present

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[6]No. 22397, I-R. 121; No. 22398, I-R. 177-78.

[7]No. 22397, I-R. 80-82; No. 22398, I-R. 116-19.

[8]No. 22397, I-R. 81; No. 22398, I-R. 116.

[9]The 1951-52 Case was formally heard by this Court on two separate occasions, in Nos. 16438 and 18506 of the files of this Court. The opinions of this Court are reported at 297 F.2d 345 (1962) and 330 F.2d 16 (1964). Citations to proceedings in the 1951-52 Case shall be made throughout this brief. This Court may take judicial notice of said prior proceedings and of the materials in its files. *Gullo v. Veterans Housing Assn.*, 269 F.2d 517 (D.C. Cir. 1959); *Hicks v. Holland,* 235 F.2d 183 (6th Cir. 1956), *cert. den.* 352 U.S. 855 (1956).

parties litigated the proper depletion computation method with respect to California Portland's Colton Quarry[10] for the immediately preceding taxable years 1951-52. The 1951-52 Case determined (i) the depletion base against which the pertinent calcium carbonates percentage depletion rate[11] was to be applied (the constructive value of the kiln feed prior to introduction into the kiln), and (ii) the method of arriving at such constructive value.[12]

The facts with respect to the quarrying and cement producing operations at the Colton Quarry during the taxable years 1953-59 are in all material respects identical to the facts determined in the 1951-52 Case.[13] Similarly, the facts with respect to the quarrying and cement producing operations at the Mojave and Rillito Quarries during the years concerned[14] are also identical in all material respects to the facts determined in the 1951-52 Case.[15]

In the proceedings below, California Portland contended that the depletion computation method determined in the 1951-52 Case should be applied for the years 1953-59 because (i) the Government had had its day in court and should be collaterally estopped from relitigating the merits of the 1951-52 Case, and (ii) the 1951-52 Case had been correctly decided and was *stare*

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[10]As used herein, the term "quarry" shall include both the quarry itself and the nearby rock processing and cement plant.

[11]The percentage depletion rate allowed for calcium carbonates was 10% for the years concerned in the 1951-52 Case and for the first year and 245/365ths involved in the present case. For periods thereafter, the allowable rate was 15%. See, e.g., No. 22398, I-R. 188.

[12]The complete text of the final decision in the 1951-52 Case is unofficially reported at 66-2 USTC para. 9624. The official text of said decision is contained at R. 5-36 (particularly 23-36) in No. 18506, as amended by Pltf. Ex. 9 herein.

[13]No. 22398, I-R. 117, 185-86.

[14]1956-59 for Mojave and 1953-57 for Rillito.

[15]N. 13, *supra;* No. 22397, I-R. 81, 125-26.

decisis. The Government did not question that the purpose of the depletion computation was to arrive at a constructive value of the kiln feed, but argued that the method of arriving at such constructive value should be different from that determined in the 1951-52 Case.

The District Court held that the depletion computation method determined in the 1951-52 Case should be applied in the present case.[16] California Portland has cross-appealed from this decision for protective purposes only, and seeks to depart from the 1951-52 Case computation only if this Court does not affirm the District Court.

Questions Presented.

1. Is the Government collaterally estopped from attacking in this proceeding the depletion computation method determined in the 1951-52 Case?

2. Was the District Court correct in applying for the taxable years 1953-59 the same depletion computation method determined for the immediately preceding taxable years in the 1951-52 Case?

3. If the District Court is not affirmed by this Court, should loading costs be treated in accordance with California Portland's alternative contention?

Specification of Error for California Portland's Cross-Appeal.

1. California Portland believes that the 1951-52 Case should dispose of the instant litigation, and that the District Court's reliance thereon was correct. At the trial, however, California Portland advanced an alternative position with respect to treatment of loading

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[16]Compare the computation method for each year here concerned as specified at I-R. 131-46 in No. 22397 and I-R. 192-224 in No. 22398, with the 1951-52 Case computation method set forth at R. 5-36 (particularly 23-36) in No. 18506, as amended by Pltf. Ex. 9 herein.

costs. Said alternative was not adopted by the District Court, and California Portland alleges that this was error only in the event that this Court does not affirm the computation method adopted by the District Court below and in the 1951-52 Case.

Summary of Argument.

The Government insists on relitigating for 1953-59 the identical depletion computation established in the 1951-52 Case. We believe such relitigation is inequitable, an unwarranted burden on the courts and California Portland, and foreclosed by the principle of collateral estoppel. Accordingly, we submit that this principle provides the first basis for affirmance of the judgment of the District Court.

Assuming *arguendo* that it is proper to reach the merits, we further submit that the District Court's refusal to change the computational method developed after seven years of litigation in the 1951-52 Case was clearly correct.

The Government's position that the costs and revenues of sacked cement should be included in the depletion computation ignores the express "first marketable product" requirement of the pertinent Regulation, results in *two* constructive prices for a single, fungible product—kiln feed, and disregards the great preponderance of the judicial authorities.

The Government's argument that selling expenses do not benefit the entire mining-manufacturing operation of an integrated taxpayer ignores common sense, its own Regulations, and controlling precedent. This position also disregards the entire purpose of the depletion computation, which is to construct a hypothetical sales price for kiln feed equal to that which would be charged by a nonintegrated producer of that product.

With respect to cash discounts, the Government disregards the express findings of the District Court pertaining to their nature and purpose in the present case. The Government also ignores the fact that its own principal judicial authority is in complete accord with the 1951-52 Case and the District Court's judgment on this point.

The final question raised by the Government's appeal involves the costs of storage and handling certain pre-kiln additives, and is *de minimus*. Contrary to the Government's contention, we believe this cost is clearly necessary and incidental to the blending of such additives with California Portland's in-process calcium carbonate rock.

There is authority for treatment of California Portland's loading and shipping costs on a basis more favorable to it than the treatment prescribed in the 1951-52 Case and by the District Court. Although this alternative treatment would result in a substantial tax refund, California Portland seeks to depart from the 1951-52 Case computation only if this Court does not affirm the District Court.

ARGUMENT.

I.

THE GOVERNMENT IS COLLATERALLY ESTOPPED FROM ATTACKING THE JUDGMENT OF THE DISTRICT COURT.

To simplify our discussion of the collateral estoppel issue, we shall analyze the circumstances pertaining to California Portland's Colton Quarry during the taxable years 1951-52, and during the immediately succeeding taxable years 1953-59.[17]

As mentioned previously, the facts pertaining to the extraction and processing of calcium carbonate rock into finished cement and the sale thereof (as well as all other material facts) at the Colton Quarry were unchanged during the entire period 1951-59.[18] The parties and depletion computation issue in the present case are identical with those in the 1951-52 Case,[19] and, with respect to the Colton Quarry, the single difference in the present case from the 1951-52 Case is the circumstance that different taxable years are involved. The depletion computation method determined in the 1951-52 Case resulted from a litigation which required more than seven years to conclude, and involved three trials in the District Court and three appeals to this Court.[20] Under well established principles of col-

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[17]This accords with the way in which the cases were briefed and argued below. See, e.g., Gov't. Op. Tr. Br. 3, n. 1.

[18]See n. 13, *supra.*

[19]See, e.g., n. 16, *supra.*

[20]See I-R. and II-R. in No. 16438, at 160-778; R. in No. 18506 at 49-169; Pltf. Ex. 8; 297 F.2d 345 (1962); 330 F.2d 16 (1964); Pltf. Ex. 9 and 10. Suit was commenced in the 1951-52 Case on February 13, 1958, and was not concluded until May 25, 1965, when the Government's appeal to this Court from the District Court's judgment entered February 16, 1965 was dismissed.

lateral estoppel, the Government should not be permitted to relitigate for 1953-59 the depletion computation method which was so painstakingly determined for 1951-52. See, e.g., *Commissioner v. Sunnen,* 333 U.S. 591 (1948);[21] *Tait v. Western Maryland Ry. Co.,* 289 U.S. 620, 623 (1933); *Union Bag-Camp Paper Corp. v. United States,* 366 F.2d 1011 (Ct. Cl. 1966).

(a) The Alleged Compromise.

In argument below, the Government attempted to justify its present relitigation by claiming that, despite the three trials and three appeals in the prior case, that case was not determined on the merits but instead was compromised by private agreement.[22] The record in the 1951-52 Case establishes that this simply is not true.

The first trial in the 1951-52 Case was held before Judge Mathes in the then Southern District of California during October 16-23, 1958.[23] The two primary issues were (i) the nature of California Portland's Colton mineral deposit and (ii) the appropriate method of computing its percentage depletion allowance. Within the latter issue were subsidiary questions such as the treatment of cash discounts and of expenses and revenues attributable to the sale of a portion of California Portland's cement in sacks rather than in bulk.[24]

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[21]". . . [M]atters which are actually litigated and determined in the first proceeding cannot later be relitigated. Once a party has fought out a matter in litigation with the other party, he cannot later renew that duel . . . . Collateral estoppel operates, in other words, to relieve the government and the taxpayer of 'redundant litigation of the identical question of the statute's application to the taxpayer's status.'" *Commissioner v. Sunnen, supra.,* 333 U.S. at 598, 599.

[22]See, e.g., Gov't. Op. Tr. Br. 26-29.

[23]II-R. in No. 16438 at 780-81.

[24]I-R. in No. 16438 at 130-52, particularly Findings 13, 14 and 26 at 138-39, 143-44.

The District Court's Findings, Conclusions, and Judgment in the first trial determined (i) that the Colton mineral deposit consisted of calcium carbonates rather than marble,[25] (ii) that California Portland's depletion base was the value of its finished cement,[26] and (iii) the proper treatment of cash discounts, sacking, and certain "additives" in the depletion computation.[27] The Government appealed said judgment to this Court, alleging error in the District Court's classification of the mineral deposit, allowance of the value of finished cement as the depletion base, and treatment of sacking and additives in the depletion computation. The Government did not contest the District Court's treatment of cash discounts in the computation.[28]

While the first appeal in the 1951-52 Case was pending before this Court, the United States Supreme Court decided *United States v. Cannelton Sewer Pipe Co.,* 364 U.S. 76 (1960); Congress enacted Public Laws 86-564 (74 Stat. 290) and 86-781 (74 Stat. 1017); and California Portland made a timely election to have all open taxable years governed by such legislation. The net result was that California Portland's depletion computation was required to construct a value of its mineral product at the processing point of introduction of the kiln feed into the kiln, rather than at the point of finished product sale. This Court affirmed the District Court's classification of the Colton mineral deposit, and, in view of California Portland's election of treatment under Public Law 86-564, remanded the cause for the District Court's determination of the proper deple-

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[25]I-R in No. 16438 at 137.

[26]*Id.* at 143-44 (Findings 26 and 27).

[27]*Id.* at 139, 144 (Findings 14 and 26), 138-39, 144 (Findings 13 and 26) and 139 (Finding 15).

[28]II-R. in No. 16438 at 786-87.

tion computation method using the new kiln feed cut-off point.[29]

At the second trial the District Court entered new findings and conclusions which defined a depletion computation method using the kiln feed cut-off point and which, in particular, (i) re-entered the unappealed treatment of cash discounts developed at the first trial,[30] (ii) excluded the costs and revenues of sacking cement from the computation,[31] and (iii) specified the treatment in said computation of certain pre-kiln additives.[32] The Government again appealed to this Court, alleging as error only the District Court's treatment of pre-kiln additives in its revised depletion computation.[33] The Government again did not appeal from the District Court's treatment of cash discounts, nor did it appeal from the treatment of sacking or any other aspect of the District Court's second trial depletion computation apart from the treatment of pre-kiln additives.[34]

On appeal, the Government conceded that the cost of blending pre-kiln additives with the calcium carbonate rock was a "mining" cost, and the point considered by this Court was restricted to the narrow question of whether the acquisition cost of such additives was also a "mining" cost. This Court resolved this point in favor of the Government, and the case was again remanded to the District Court.[35]

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[29]*Riddell v. California Portland Cement Co.,* 297 F.2d 345 (9th Cir. 1962).

[30]R. 12, 18 in No. 18506 (Findings 13 and 29).

[31]*Id.* at 17 (Finding 28).

[32]*Id.* at 12, 18 (Findings 14 and 29).

[33]*Id.* at 171.

[34]*Ibid.*

[35]*Riddell v. California Portland Cement Co.,* 330 F.2d 16 (9th Cir. 1964).

At the third proceeding before the District Court, the parties represented that the single substantive question remaining was the treatment in the depletion computation of the cost of storing and handling pre-kiln additives on the taxpayer's premises, after acquisition but prior to blending with the calcium carbonate rock.[36] Because of the small amount involved, and to avoid a separate trial on this point alone, the Government was willing to concede to California Portland's treatment of such cost.[37] It did not want to be bound by such concession for future years, however, because what was then a *de minimus* question might subsequently achieve financial importance.[38] Accordingly, the Government proposed that the parties stipulate to a dollar amount of judgment, and not request the District Court to make any findings of fact or conclusions of law.[39] This procedure was unacceptable to counsel for California Portland, however, because he wished to make binding for future years all of the elements of the depletion computation which had been litigated, judicially determined, and not appealed. California Portland's counsel specifically stated that he did not wish the entire previous litigation and judicial determinations to be nullified for collateral estoppel purposes merely because of a compromise at the third proceeding on one small point.[40] Judge Mathes stated that the second trial

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[36]Pltf. Ex. 8, pp. 5-6, 11-16.

[37]*Id.* at 5-6.

[38]*Id.* at 16.

[39]*Id.* at 5-6, 10, 16.

[40]"MR. PEELER: Your Honor, the plaintiff has this problem: As you recall, this is, in effect, the third trial. We have had a series of Government counsel, each of whom, with all due respect, has had new ideas as to depletion. We have some twelve taxable years subsequent to the years in suit which presumably are governed by the principles of this litigation.

"We would hardly be anxious to settle this case just on a money-judgment basis, and then be faced with another seven or

findings and conclusions which had not been appealed could no longer be disputed, and that he would reenter all such unappealed findings and conclusions.[41] On this basis, discussion between the Court and counsel resulted in the suggestion that the parties stipulate to a reentry of the Court's unappealed second trial findings and conclusions, and that the Government expressly reserve its right to relitigate the treatment of handling costs of pre-kiln additives.[42] The Government's attorney stated that he thought the unappealed findings and conclusions were still valid and that updated findings and conclusions would not be necessary.[43] He was agreeable, however, to the above suggested proce-

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eight years of trial on the later years. In other words, those matters which are resolved in this action, such as the sacking and the discounts, we want to treat as finally resolved for all times; unless the Government can show a material change in the facts for later years.

"THE COURT: Well, those items cannot be disputable.

"MR. PEELER: We hope they are no longer in dispute.

"MR. SCHWALB: No longer in dispute for this case. They were decided by your Honor, and not appealed.

"MR. PEELER: In other words, the plaintiff's position, your Honor, is this: That we are entitled in any final decision by this court to have definitive findings of fact and conclusions of law.

"Now, as to some 95 per cent of the findings and conclusions entered by this court at the time of the second trial there either was no appeal to the Ninth Circuit, or there was a concession before the Ninth Circuit, so that those findings and conclusions should still stand as is.

"All we are asking is that they be updated to reflect the decision of the Ninth Circuit; and further that the computations, the schedule computing depletion allowance and refund which were made a part of earlier findings have substituted for them the new computations that we have submitted to the Government at this stage." Pltf. Ex. 8, pp. 7-8.

[41]"THE COURT: Well, those items [referring to previously resolved matters such as the treatment of sacking and discounts] cannot be disputable . . . . I would readopt all the findings of fact and conclusions of law that were not expressly appealed from, of course." Pltf. Ex. 8, pp. 7, 20.

[42]Pltf. Ex. 8, pp. 10-11, 16, 17-18.

[43]*Id.* at 10, 16.

dure,[44] but did not wish by his stipulation to deprive the Government of any right which it might otherwise have. If the Government was to be bound by collateral estoppel in future years, he desired that this condition exist as a matter of law rather than as a result of his consent to such effect.[45] The procedure for updating the unappealed second trial findings and conclusions was therefore agreed upon as follows:

> "THE COURT: Let's start this way: Let's incorporate by reference in a new set of findings the certain portion of the findings and conclusions heretofore made that were not appealed from, and then go from there. Where does that leave us? . . . .
>
> "MR. PEELER: . . . [W]e would be willing to accept a limited reservation on the part of the Government that their concession insofar as this intermediate area of the handling costs of the additives prior to the blending concerned is for purposes of this action only and will not be binding in the future.
>
> "THE COURT: Won't that meet the situation?
>
> "MR. SCHWALB: It does, except my proposed stipulation for judgment and form of judgment accomplish the same purpose.
>
> "THE COURT: Except there is always the problem that a reversal and remand, ipso facto, works as a setting aside of all the findings of fact and conclusions of law and judgment . . . .

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[44] *Id.* at 16, 17-18.

[45] "MR. SCHWALB: And although now it doesn't seem, as a matter of law, that we have to be too concerned, nevertheless I wouldn't want it as a matter of record that I have stipulated and that the Government would be so bound. *If the collateral estoppel principle is against us, it will be as a matter of law rather than by my agreement.*" Pltf. Ex. 8, pp. 20-21. (emphasis added)

"MR. SCHWALB: Could we do this to avoid any problem—and I do envision some problem in rewording the findings, and it is just going to prolong it. So would something like this do, a stipulation that those findings and conclusions not appealed from by the Government will stand as the findings and conclusions in this case with respect to all items *other than this one item of purchased additives*. With respect to the purchased additives, X-dollars shall be treated as mining, and Y-dollars be treated as non-mining; and the treatment of X-dollars as mining will not bind the Government for future years . . . .

"MR. PEELER: A stipulation such as just mentioned we could do right now. * * *"[46] (emphasis added)

In accordance with the above procedure, the parties executed and filed in the 1951-52 Case the document which is Plaintiff's Exhibit 9 in this case. Essentially, Exhibit 9 agreed to reentry without change of the unappealed second trial findings of fact and conclusions of law, and made appropriate modifications to the treatment of purchased additives which had been the subject of the second appeal to this Court. Finding 33 of said Exhibit 9 provides in its entirety as follows:

"33. By agreeing to the entry of the foregoing Findings of Fact and the following Conclusions of Law, the defendant has not waived his objections thereto nor does the defendant concede the correctness thereof either for the taxable years in suit or subsequent taxable years. Defendant has stipulated to the entry thereof to avoid another trial for the taxable years involved and so that

[46]Pltf. Ex. 8, pp. 10-11, 16, 17-19.

> final Findings of Fact and Conclusions of Law and a final Judgment may be entered without further delay. As to certain of the costs relating to the handling of additives ($21,390.00 for the taxable year ended April 30, 1951 and $14,321.00 for the taxable year ended April 30, 1952) herein treated as mining costs (see Finding of Fact No. 30, *supra,* Conclusion of Law No. 6, *infra,* and the computations shown in Exhibit A attached hereto), the defendant has not waived his objection thereto nor conceded the correctness thereof but has stipulated to such computations in order that final Findings of Fact and Conclusions of Law, and a final Judgment may be entered for the taxable years in suit without further delay."

The Government now argues that the above procedure constituted a compromise of the entire merits of the 1951-52 Case, and therefore that said case does not collaterally estop it from relitigating the identical matters here. We respectfully submit that the transcript of the third proceeding before Judge Mathes makes it clear that the only compromise on the merits was with respect to the *de minimus* question of the handling cost of pre-kiln additives, and that as to all other substantive matters the parties agreed only to a *procedure* to effect reentry of the unappealed second trial findings and conclusions. The fact that the Government did not compromise or agree to the entire merits of the 1951-52 Case is explicitly stated in Finding 33:

> "By agreeing to the entry of the foregoing Findings of Fact and the following Conclusions of Law, the defendant has not waived his objections thereto nor does the defendant concede the correctness thereof *either for the taxable years in suit* or subsequent taxable years. . . ." (emphasis added)

In addition, had there been a compromise of the entire merits, the Government would have had no right to appeal the settlement it had made.[47] On April 14, 1965, however, the Government again made clear that it did not consider the merits of the 1951-52 Case to be concluded by settlement or compromise, and appealed to this Court from the District Court's judgment.[48]

We believe that the foregoing establishes beyond question that the Government's stipulation to the procedure for reentry of the unappealed second trial findings and conclusions represents no more than a variation of the typical case where, after trial and a statement by the trial judge of the way he will rule, the parties agree to the form of findings, conclusions, and judgment, but do not agree on the merits.[49]

In *United States v. International Building Co.*, 345 U.S. 502 (1953), an attempt was made to give collateral estoppel effect to a judgment of the Tax Court which had been entered after a stipulation that there was no deficiency, and without hearing, briefs, or argument. In holding that the parties' agreement on the merits prevented the judgment from having collateral estoppel effect, the Court stated:

> "There is no showing either in the record or by extrinsic evidence [citation omitted] that the issues raised by the pleadings were submitted to the Tax Court for determination or determined by that court. . . . *A judgment entered with the con-*

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[47]See, e.g., *Swift & Co. v. United States*, 276 U.S. 311, 323-24 (1927); Note, *The Consent Judgment as an Instrument of Compromise and Settlement*, 72 HARV. L. REV. 1314, 1323 (1959).

[48]Pltf. Ex. 10.

[49]See, e.g., Local Rule 7(a) of the District Court. Indeed, the very concept of "findings" implies adjudication. See F.R.C.P. 52(a).

> *sent of the parties may involve a determination of questions of fact and law by the court.* But unless a showing is made that that was the case, the judgment has no greater dignity, so far as collateral estoppel is concerned, than any judgment entered only as a compromise of the parties." 345 U.S. at 505-06. (emphasis added)

In the present case, California Portland's entire percentage depletion method was fully litigated and determined at the second trial of the 1951-52 Case. The only facet of such depletion method which then was appealed was the narrow question of the treatment of pre-kiln additives. On remand the Government was not entitled to re-open the unappealed second trial findings and conclusions absent exceptional circumstances,[50] it made no such effort, and the District Court stated that it would reenter the unappealed findings and conclusions without change. In these circumstances, the parties' stipulation as to the *procedure* for reentry of the unappealed second trial findings and conclusions clearly resulted in a judgment which "involve[d] a determination of questions of fact and law by the court," as expressly contemplated with respect to such procedure by the above italicized language of *International Building Co.*

(b) The Alleged Change in the "Legal Atmosphere."

The Government's alternative argument in support of its relitigation of the points established in the 1951-52 Case was that there had been a compelling change in the "legal atmosphere" respecting the depletion computation since the entry of judgment in the 1951-52 Case.

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[50]E.g., *White v. Higgins,* 116 F.2d 312, 317 (1st Cir. 1940).

As its primary authority for this position it cited *Standard Lime & Cement Co. v. United States,* 329 F.2d 939 (Ct. Cl. 1964), and placed secondary reliance upon *Whitehall Cement Mfg. Co. v. United States,* 369 F.2d 468 (3d Cir. 1966).

The courts have been explicit in prescribing the type of change in the case law required to make collateral estoppel inapplicable.[51] Thus, there must be either a

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[51]For example, in *Commissioner v. Sunnen,* 333 U.S. 591 (1948), the landmark Supreme Court *Clifford-Horst* line of decisions had greatly altered the tax law of intra-family transactions between the date of the judgment claimed to have collateral estoppel effect and the second suit. In holding that such intervening Supreme Court pronouncements must override the lower court judgment in the earlier case, the Court stated:

> ". . . [A] subsequent modification of the significant facts or a change or development in the *controlling legal principles* may make that determination *obsolete or erroneous,* at least for future purposes . . . . [The principle of collateral estoppel] is not meant to create vested rights in decisions that have become obsolete or *erroneous with time,* thereby causing inequities among taxpayers . . . . [*W*]*here the situation is vitally altered* between the time of the first judgment and the second, the prior determination is not conclusive . . . . While . . . a state court decision may be considered as having changed the facts for federal tax litigation purposes, a modification or growth in *legal principles as enunciated in intervening decisions of this Court* may also effect *a significant change* in the situation." 333 U.S. 599, 600. (emphasis added)

In *Fairmont Aluminum Co.,* 22 T.C. 1377 (1954), *aff'd* 222 F.2d 633 (4th Cir. 1955), the Tax Court commented on *Sunnen* as follows:

> "The situation therein involved broad conceptual differences in legal thinking between the first proceeding and the second, and the Supreme Court approved the characterization of the series of decisions between the first and the second proceedings as *'an intervening legal development . . . which makes manifest the error of the result reached' in the earlier case* . . . . We think that the principle of the *Sunnen* case does not encompass so narrow a 'change' as is present here since the situation between the prior proceeding and the present one has not been 'vitally altered.'" 22 TC at 1383. (emphasis added)

(This footnote is continued on the next page)

"decisive change in the law"[52] or "an intervening legal development . . . which makes manifest the error of the result reached . . . [in the earlier case]."[53]

(i) As discussed below, instead of disagreeing with the depletion computation developed in the 1951-52 Case, the judgment in *Standard Lime* substantially supports the 1951-52 Case computation. On the major points of the treatment of cash discounts and of the costs and revenues of sacking, the *Standard Lime* judgment computation is identical with the 1951-52 Case. On the treatment of loading and shipping costs, *Standard Lime* does disagree with the 1951-52 Case computation, but resolves this point in a manner *more favorable to the taxpayer* than did the 1951-52 Case. (*Standard Lime* did not consider the other main point herein of the proper treatment of selling costs.) We cannot understand how the Government can seriously contend that *Standard Lime* changes the "legal climate," when it is so closely consistent with the 1951-52 Case and the Government itself refuses to follow the *Standard Lime* treatment of the points here pertinent.

(ii) Even if the *Standard Lime* result could somehow be viewed as inconsistent with the 1951-

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Similarly, both the Seventh and Eighth Circuits have stated that the change in "legal atmosphere" contemplated by *Sunnen* occurs "only if there has been a decisive change in the law." *Lynch v. Commissioner*, 216 F.2d 574, 580 (7th Cir. 1954); *Dr. Salsbury's Laboratories v. Russel Laboratories*, 212 F.2d 414, 416 (8th Cir. 1954). The Internal Revenue Service takes the same position in GCM 26399, 1950-2 C.B. 8, where it is stated:

> "The [Sunnen] Court held in effect that the doctrine of collateral estoppel has no application when a subsequent decision *of a court of last resort* has effected a change in the applicable legal principles." (emphasis added)

[52] *Lynch v. Commissioner*, 216 F.2d 574, 580 (7th Cir. 1954).

[53] *Commissioner v. Sunnen*, 333 U.S. 591, 603 (1948).

52 Case, it is clear that the 1951-52 Case would be the case changing the "legal climate" rather than *Standard Lime*. *Standard Lime* was decided one month *before* the decision of this Court in the second appeal of the 1951-52 Case and 11 months *before* the District Court's entry of final judgment in that case. If the Government really believed that *Standard Lime* changed the "legal atmosphere," it had ample opportunity to make this assertion prior to entry of final judgment in the 1951-52 Case.[54]

(iii) *Whitehall Cement* also does not change the "legal atmosphere." On the important point of the treatment of selling expenses, *Whitehall* is direct authority in support of the 1951-52 Case computation. *Whitehall* does support the Government's position respecting the treatment of the costs and revenues of sacking, but, as discussed below, this is a minority view.[55] We shall show that the main considerations on this point were not presented to the *Whitehall* court, and that the overwhelming weight of the authorities (including the *Victorville* decision of this Court) support the 1951-52 Case treatment of sacking.

As discussed *infra,* the great preponderance of the authorities continues to support the depletion computation developed in the 1951-52 Case and applied by the court below. Accordingly, we respectfully submit that the Government is completely unjustified in requiring

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[54]Contrast the effect of the Supreme Court's intervening decision in *Cannelton* on the first appeal in the 1951-52 Case. *Riddell v. California Portland Cement Co.,* 297 F.2d 345 (9th Cir. 1962).

[55]In fact, *Whitehall* is the only case which the Government has cited on this point.

California Portland and the courts to submit to a relitigation for 1953-59 of the same depletion computation which was so laboriously determined in the 1951-52 Case.

(c) The Effect of the 1951-52 Case on the Depletion Computation of the Arizona Company.

The Government contends that the 1951-52 Case has no bearing on the Arizona Company's depletion computation. We believe this is clear error.

During the period of the Arizona Company's operations concerned herein (1953-57), that company was at all times a wholly owned subsidiary of California Portland.[56] Effective August 31, 1961, it was merged into California Portland.[57] The District Court made the following finding with respect to the Arizona Company (referred to therein as "Taxpayer"):

> "17. During the taxable years ended April 30, 1953, April 30, 1954, April 30, 1955, April 30, 1956, and April 30, 1957, the relevant facts and circumstances pertaining to the Taxpayer's (i) production of cement clinker, bulk cement, sacked cement and the marketing thereof, (ii) cash discount practices, and (iii) selling expenses, were in substance identical with the relevant facts and circumstances pertaining to such items of the plaintiff [California Portland] during the earlier taxable years ended April 30, 1951 and April 30, 1952, as found by this Court in the action captioned *California Portland Cement Co. vs. R. A.*

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[56]No. 22397, I-R. 120.

[57]*Ibid.*

> *Riddell, District Director of Internal Revenue, Los Angeles District* (No. 135-58 WM, Civil), decided on February 16, 1965. At all times relevant hereto, the Taxpayer has been and now is in privity with the plaintiff."[58]

This Finding is clearly supported by the evidence.[59]

The identical circumstances here concerned were before the District Court in *Monolith Portland Cement Co. v. Riddell,* and *Monolith Portland Midwest Co. v. Riddell.*[60] In *Monolith,* the taxpayer was a cement producer with respect to which the District Court had previously determined the method of computing its percentage depletion for the taxable year 1951.[61] In a second action involving the taxable year 1952, the Government sought to reopen the previously established method of computing the taxpayer's depletion. The District Court held that collateral estoppel applied, as follows:

> "The defendant asserts that issues of fact do exist with regard to the character or classification of plaintiff's limestone, whether plaintiff's processes were ordinary and those usually applied, and what was plaintiff's commercially marketable mineral product in 1952.
>
> "In the Court's view, all of these issues were litigated and decided adversely to this defendant's privy, the United States of America, in the 1951

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[58]*Id.* at 125-26.

[59]E.g., *id.* at 80-81, 120.

[60]Unofficially reported at 60-1 USTC para. 9187 and 62-2 USTC para. 9750, respectively.

[61]168 F. Supp. 692; *aff'd and remanded,* 269 F.2d 629 (9th Cir. 1959).

> case . . . [citations omitted]. Hence such issues are not now available to the defendant here, under the doctrine of res judicata and collateral estoppel. *The Government may not force the plaintiff to relitigate each tax year the question of the depletion statute's applicability to plaintiff's status, where the undisputed and admitted facts show that such status has remained unchanged.*" (emphasis added)

The same result was reached by the District Court in the *Midwest* case, where Monolith's wholly owned subsidiary, Midwest, was held in privity with Monolith and entitled to the collateral estoppel effect of the 1951 litigation involving Monolith.[62]

Based upon the foregoing, we believe that the 1951-52 Case collaterally estops the Government from attacking the Arizona Company's depletion computation, as well as that of California Portland. Even if collateral estoppel were held inapplicable to the Arizona Company, however, the 1951-52 Case should still control that company's depletion computation as a matter of *stare decisis,* since the facts in the two cases are in substance identical.

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[62]Subsequent to the District Court's holdings in *Monolith* and *Midwest* and while such decisions were on appeal to this Court, *United States v. Cannelton Sewer Pipe Co.,* 364 U.S. 76 (1960), was decided by the United States Supreme Court. This event, which shifted the depletion cut-off from the end product to an intermediate processing stage, constituted a true change in the "legal atmosphere," and both *Monolith* and *Midwest* were reversed solely on the basis of *Cannelton.* As previously discussed, no such change in the "legal atmosphere" has occurred in the present case, and therefore the District Court's *Monolith* and *Midwest* decisions are direct authority for applying collateral estopped here.

II.

THE RELIANCE OF THE DISTRICT COURT UPON THE RESULT REACHED IN THE 1951-52 CASE IS SUPPORTED BY THE MERITS AS WELL AS BY COLLATERAL ESTOPPEL.

A. Introduction.

As previously discussed, the facts in the instant case are identical in all material particulars with those in the 1951-52 Case.[63] This portion of our brief will examine the merits of the depletion computation determined in the 1951-52 Case, and shall demonstrate that the District Court's adherence to that computation was correct and should be affirmed.

A miner of calcium carbonates such as California Portland[64] is entitled to a percentage depletion deduction at the rate of 15%.[65] The sole substantive issue in this case is the proper method of computing the amount against which such 15% rate is to be applied (herein called the "depletion base").

The purpose of the depletion deduction is to compensate for the exhaustion of a taxpayer's mineral deposit, and to provide an inducement for mineral exploration and development.[66] The statute has been drafted to

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[63]Nn. 13 & 15, *supra.*

[64]To simplify discussion of the merits, reference shall be limited to the case of California Portland, since the material facts and the depletion computation pertaining to California Portland and the Arizona Company are identical. The Government agrees with this approach. Gov't. Op. Tr. Br. 3, n. 1.

[65]Int. Rev. Code of 1954, § 613(b)(7). (See also n. 11, *supra.*) Such 15% rate is subject to a limit of "50% of the taxpayer's taxable income from the property" (Section 613(a)), but in this case the 15% depletion allowances are significantly less than the 50% limit.

[66]*United States v. Cannelton Sewer Pipe Co.*, 364 U.S. 76 (1960) [hereinafter cited as *"Cannelton"*].

permit the deduction not only with respect to the value of the mineral in the ground, but also with respect to certain processes necessary to extract the mineral and to place it in a condition so it may be sold ("mining processes").[67] Beyond this point, however, the right to depletion ceases, and processes applied thereafter to change the mineral into a different product ("manufacturing processes") are not depletable.[68]

The simplest case is that of a nonintegrated miner, selling raw mineral after extraction but prior to the application of any process considered as manufacturing. In such case the depletion base is the miner's entire gross income from the sale of the raw mineral product.[69]

Difficulty is encountered when the taxpayer is both a miner and a manufacturer, extracting the raw mineral and then processing it into what the law considers to be a manufactured product. If the mineral processed by the miner-manufacturer is the same as that extracted and sold in commercial quantities by nonintegrated miners in his market area, the miner-manufacturer is required to use as his depletion base the local price of the raw mineral.[70] Where, as in the present case, the miner-manufacturer processes mineral which is not sold by nonintegrated miners, to determine the depletion base it is necessary to construct an artificial price at a point where the law presumes a nonintegrated miner would sell, if in fact there had been any demand for the mineral at such stage of processing.[71]

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[67]Section 613(c); *Cannelton.*

[68]*Cannelton.*

[69]Section 613(c); INT. REV. CODE OF 1939, Reg. 118, § 39.23-(m)-1(e) [hereinafter referred to as "Regulation 118"]; *Cannelton.*

[70]*Cannelton.*

[71]Subsection (3) of Regulation 118.

With respect to producers of cement, Congress has enacted an elective[72] provision that such point of presumed sale at which "mining" ends and "manufacturing" begins is the point in the cement production process where the raw mix is ready for introduction into the rotary kilns (herein called "the kiln feed cut-off").[73] California Portland made a timely election to be governed by this provision[74] and, accordingly, must compute its depletion base at the price at which nonintegrated miners would sell kiln feed. In fact, however, no one sells kiln feed,[75] and therefore it is necessary to take the price of the first commercially[76] marketable product of the cement making process, and work back from that price to construct a theoretical price for kiln feed. Such construction of a theoretical price for kiln feed from the price of the subsequent product is accomplished by the proportionate costs and

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[72]The provision is elective with respect to taxable years commencing prior to January 1, 1961. Thereafter it is mandatory. P.L. 86-564 (74 Stat. 290); P.L. 86-781 (74 Stat. 1017).

[73]Section 613(c)(4)(F); P.L. 86-564 (74 Stat. 290); P.L. 86-781 (74 Stat. 1017).

[74]No. 22398, I-R. 151; No. 22397, I-R. 103-04.

[75]Pltf. Ex. 20-B, 186-87. Pursuant to stipulation, the affidavits of certain witnesses and deposition testimony thereon were treated as direct testimony at the trial. Tr. 56; No. 22398, I-R. 130-32; No. 22397, I-R. 61-63.

[76]The Government claims that the District Court was confused in relying on the concept of a "commercially" marketable product. App. Br. 29-32. Subsection (3) of Regulation 118 does speak of the "first marketable product." In subsection (2), however, it makes clear that this reference is to a "commercially" marketable product. The point was important below, because the Government then contended that California Portland's *de minimus* sales of cement clinker established its "first marketable product" and the starting point for its depletion computation. This was clearly erroneous because cement clinker is not a "commercially" marketable product (see, e.g., Pltf. Op. Tr. Br. 72-82), and the Government now admits that California Portland has no "first marketable product" prior to finished cement. App. Br. 34.

profits computation specified in subparagraph (3) of Section 39.23(m)-1(e) of Regulation 118 under the Internal Revenue Code of 1939 (which provision is hereinafter referred to as "Regulation 118").[77]

The computation requires that the costs of producing the first commercially marketable product of the cement making operation be allocated to either mining processes or manufacturing processes. After such allocation, the depletion base constructive kiln feed price is that percentage of the price of the first commercially marketable product which the costs attributable to mining processes bear to the total costs attributable to the mining and manufacturing processes resulting in the first commercially marketable product.[78]

In the present case the areas of disagreement are (i) the selection of the first commercially marketable product to be used as the starting point for constructing the kiln feed price and (ii) the allocation of specific costs to either mining or manufacturing.

The selection of the first commercially marketable product makes a substantial difference in the constructive kiln feed price, because the marketable product sales price is the amount against which the ratio developed by Regulation 118 is applied. Thus, if the Regulation 118 ratio was 30%, the constructive kiln feed price would change substantially depending on whether

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[77]Regulation 118 was made applicable to 1954 Code years by T.D. 6091, 1954-2 C.B. 47.

[78]The above is intended merely to summarize the pertinent computational provision. These matters are developed in detail, *infra.*

the first commercially marketable product had a price of $100 or $150. In similar manner, the characterization of costs as attributable to either mining or manufacturing is also very important, because a determination that a cost is a "mining cost" increases the Regulation 118 ratio (and the constructive kiln feed price) while the converse is true if it is determined that such cost is attributable to manufacturing.

The specific questions on the merits of the depletion computation developed in the 1951-52 Case and applied by the District Court below are as follows:

(a) Whether California Portland's first commercially marketable product is bulk cement or sacked cement.

(b) The proper treatment in the depletion computation of selling expenses.

(c) The treatment of cash discounts.

(d) The treatment of the costs of handling certain pre-kiln "additives."

In addition to the above matters, there is a further question of the propriety of California Portland's alternative treatment of loading and shipping costs. California Portland seeks to raise this alternative contention only if this Court does not adhere to the depletion computation established in the 1951-52 Case and by the District Court.

Since the income from California Portland's first commercially marketable product is the starting point for the Regulation 118 computation, item (a) above shall be discussed first.

B. California Portland's First Commercially Marketable Product.

1. The Proper Starting Point for the Regulation 118 Computation Is the Sale of Cement in Bulk. Sacked Cement Is Not the First Marketable Product and Should Be Excluded From the Computation.

Regulation 118 provides in pertinent part as follows:

> "(3) If the taxpayer sells the crude mineral product . . . in the immediate vicinity of the mine, 'gross income from the property' means the amount for which such product was sold, but, if the product is . . . processed (other than by the ordinary treatment processes . . .) before sale, 'gross income from the property' means the representative market or field price . . . of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes. . . . *If there is no such representative market or field price . . . then there shall be used in lieu thereof the representative market . . . price of the first marketable product resulting from any process or processes . . . minus the costs and proportionate profits attributable to . . . the processes beyond the ordinary treatment processes.*" (emphasis added)

In the present case, the statute provides that the "crude mineral product" which establishes California Portland's depletion base is the kiln feed.[79] Neither California Portland nor anyone else in the industry sells kiln feed, however.[80] Accordingly, the only provision of Regulation 118 which applies here is the portion italicized above. Said provision states that the

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[79] INT. REV. CODE OF 1954, § 613(c).

[80] Pltf. Ex. 20-A 186-87; App. Br. 19.

starting point for the depletion computation is "the representative market . . . price of the first marketable product resulting from any process or processes. . . ."[81]

The Government contends: "The first 'marketable product' was finished cement; the finished cement was sold both in bulk and in bags."[82] This assertion that the *first* marketable product was *both* bulk and sacked cement has no basis in the record, and the Government does not even attempt a record reference. The District Court found as a fact that the first marketable product obtained from California Portland's calcium carbonate rock was bulk (as opposed to sacked) cement.[83] This finding is clearly supported by the evidence.[84]

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[81]As discussed in n. 76, the "first marketable product" must be "commercially" marketable. There is no issue whether bulk cement can be sold in commercial quantities, however, and the only question is which of two marketable products is first—bulk or sacked cement.

[82]App. Br. 34.

[83]No. 22398, I-R. 184-85; No. 22397, I-R. 124-25.

[84]More than 75% of California Portland's cement was sold in bulk, and the sacking of the remaining portion occurred after the bulk cement had been produced and was ready for sale. No. 22398, I-R. 105-10; No. 22397, I-R. 73; Pltf. Ex. 20-A 189-90. The Government's witness David Caldwell testified as follows:

> "Q. Wouldn't you describe the bagging of cement as an operation which occurred subsequent to the production of bulk cement?
>
> A. Yes, sir. There is no question about that." Pltf. Ex. 19, 118.

In response to a hypothetical question involving a taxpayer who sold one-half of his output as bulk cement and one-half as ready-mix concete. Mr. Caldwell further testified that the Regulation 118 ratio respecting the total output would have to be applied against the bulk cement price. *Id.* at 121.

Defendant's principal witness Arnold Lintz testified as follows:

> "Q. Well, where cement is sold beyond the bulk cement stage, what has your position been as to the first marketable product?

(This footnote is continued on the next page)

In *Riddell v. Victorville Lime Rock Co.*, 292 F.2d 427 (9th Cir. 1961), the taxpayer quarried and ground high grade limestone, which it sold to the paint industry for use in paint manufacture and to builders for roofing granules, stucco, and plaster. The taxpayer's production was sold both in bulk and in bags. This Court held as follows:

> ". . . [T]he district court erred in including in appellee's depletion base income attributable to bags and bagging. . . . *Bags and bagging are not required to obtain the commercially marketable mineral product.* Income attributable to bags and bagging should have been excluded. . . ." 292 F.2d at 436. (emphasis added)

At the first trial in the 1951-52 Case, the District Court held that, as to that portion of California Portland's production sold in sacks, sacked cement was the first commercially marketable product.[85] On remand after the *Cannelton* decision and California Portland's kiln feed election, the District Court followed *Victorville* and treated bulk cement as California Portland's first marketable product, excluding both the costs and revenues of sacking from the depletion computation.[86] Numerous authorities clearly establish that the treatment of sacking in *Victorville* and the 1951-52 Case was correct.

"A. It is still cement. The bags have nothing to do with the first marketable product.

"Q. What is the first marketable product of California Portland Cement on the basis of which your computations were made?

"A. Well, it includes bagged cement. This is true." *Id.* at 14.

[85]No. 16438, I-R. 138-39, 144 (Findings 13 and 26).

[86]No. 18506, R. 17 (Finding 28). As previously mentioned, the Government did not appeal this determination in the 1951-52 Case. No. 18506, R. 171.

In *United Salt Corporation,* 40 T.C. 359 (1963), *aff'd per curiam,* 339 F.2d 215 (5th Cir., 1965), the taxpayer sold about 30% of its salt in bulk and nearly 60% in sacks. In holding that the reference point for the depletion computation was the bulk product, the court stated:[87]

> "Petitioner's contention that it is entitled to determine the 'gross income from the property' on the basis of its gross income from the sale of *all* its salt products f.o.b. plant loaded for shipment . . . is untenable in view of the principles of the *Cannelton* case and cases subsequent to it. Clearly, the costs of sacking and sewing are not includable in the depletion base. . . .
>
> "We find that petitioner's depletion base is the gross income it would have received if it had sold all of its salt in the years before us as bulk salt." (original emphasis)

Similarly, in *Standard Realization Co.,* 289 F.2d 247 (7th Cir. 1961), the taxpayer mined quartzite and processed it to varying degrees of fineness. More than 60% of its product was sold in bulk. The court held that the depletion computation must be made on the basis of what the taxpayer would have received if all of its product had been sold in bulk, without consideration of sacking or other subsequent activities.

In *North Carolina Granite Corp.,* 43 TC 149 (1964), the taxpayer quarried granite which it crushed and ground and then sold for use as poultry grit or road material. The court held as follows:

> "After the screening process, the crushed granite destined for sale as poultry grit is sent through

[87] 40 TC at 368.

> spouts into the bagging room. We hold, as to this portion of petitioner's crushed granite, that 'mining' ceases when the crushed granite reaches the bagging room, and that petitioner's 'gross income from the property' is the amount it would have received if it had sold the mineral in bulk at this stage [citing *Cannelton, Standard Realization,* and *United Salt*]." 43 TC at 157.

As discussed below,[88] the Government's principal authority in this case, *Standard Lime,* is also in precise accord with the court below on the treatment of sacked cement in the depletion computation.

The next section of this brief shall show that the whole purpose of the Regulation 118 computation is to work back from the price of a product which is actually sold and construct a price or value of the kiln feed, which is not sold. Obviously the price or value of the kiln feed for a particular taxpayer should be a uniform amount, since the kiln feed is a uniform, fungible product. Therefore, a computation which, as suggested by the Government, works back from two or more products of a single taxpayer and establishes different constructive prices for its kiln feed, violates the clear purpose of the Regulation as well as its express "first marketable product" requirement. This may be illustrated by the following example:

Assume a lot of cement sold for $1300, total costs and allocable expenses of mining and manufacturing were $250 and $750 respectively, profit was $100, and

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[88]Pp. 60-61, *infra.*

expenses of sacks and sacking and sack premium were $200. Gross income from mining of the bulk cement and sacked cement would be calculated as follows:

		Bulk	Sacked
1.	Sales proceeds of bulk cement	$1100	$1100
2.	Sack premium	.....	200
3.	Total sales proceeds	$1100	$1300
4.	Production Costs and Expenses:		
5.	Mining	$ 250	$ 250
6.	Manufacturing	750	750
7.	Sacks and Sacking	.....	200
8.	Total costs and expenses	$1000	$1200
9.	Net Profit	$ 100	$ 100
10.	Regulation 118 ratio (Item 5 over item 8)	250/1000	250/1200
11.	Gross income from mining—constructive price of kiln feed (Item 10 x item 3)	$ 275	$ 271

The foregoing makes it clear that the only way to reach the required uniform depletion base of the value of the fungible product of kiln feed is to work back from the uniform price of the first marketable product. The Government's contention of working back from products other than bulk cement distorts the calculation and violates (i) the purpose of the calculation, (ii) the express language of Regulation 118, and (iii) the pertinent judicial authorities, including the *Victorville* decision of this Court.[89]

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[89]The only case which the Government has cited in its favor on the first marketable product question is *Whitehall Cement Mfg. Co. v. United States,* 369 F.2d 468 (3d Cir. 1967). We do not believe the Court was correctly informed on this point, and have discussed the case in a separate section at pp. 61-62, *infra.*

C. The Allocation of California Portland's Costs to Its Mining and Manufacturing Activities.

1. Introduction.

In the preceding section we established that bulk cement is California Portland's first commercially marketable product and the starting point for the Regulation 118 computation. The next question is the manner in which that computation works back from the sales income at said starting point to establish a constructive price or value of California Portland's calcium carbonate rock at the kiln feed cut-off point.

Subsection 613(c) of the Internal Revenue Code of 1954 provides that the depletion base shall be the taxpayer's "gross income from mining." Said subsection then defines "mining" as follows:

> ". . . (2) MINING.—The term 'mining' includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto). . . .
>
> "(4) TREATMENT PROCESSES CONSIDERED AS MINING.—The following treatment processes where applied by the mine owner or operator shall be considered as mining. . . .
>
> (F) in the case of calcium carbonates and other minerals when used in making cement—*all processes* (other than pre-heating of the kiln feed) *applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;* . . ." (emphasis added)

This statutory language makes it clear that the "mining" activities of an integrated producer of cement

stop at the kiln feed stage, and that the "gross income from mining" at that point is to be determined by allocation of costs and profits to pre-kiln feed treatment *processes* and to subsequent treatment *processes*. The same principle is established by Regulation 118:

> ". . . If there is no such representative market or field price . . ., then there shall be used in lieu thereof *the representative market . . . price of the first marketable product* resulting from any process or processes . . . *minus the costs and proportionate profits attributable to . . . the processes beyond the ordinary treatment processes.*" (emphasis added)

California Portland's first marketable product is bulk cement. Subsection 613(c)(4)(F) establishes that the "ordinary treatment processes" referred to in Regulation 118 terminate at the kiln feed stage. Accordingly, the Regulation 118 computation expressly requires that California Portland's gross income from sales of bulk cement be reduced by only the costs and proportionate profits attributable to the *processes* beyond the kiln feed cut off point, and that all of the remainder be treated as California Portland's depletion base "gross income from mining." Only a simple matter of subtraction is involved.

The Regulation 118 computation has been expressed in other ways by several courts. For example, in the principal case relied on by the Government, *Standard Lime & Cement Co. v. United States*, 329 F.2d 939 (Ct. Cl. 1964), the court anaylzed the computation as follows:[90]

> (i) The statute divides an integrated cement producer's operation into processes up to kiln feed

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[90]329 F.2d at 944-45.

and post-kiln feed processes. The first step in the computation is to determine the direct costs which are associated with each part of the total flow of processes.

(ii) The second step is to determine the indirect costs which are incurred for the benefit of the entire operation. These are allocated to pre and post kiln feed processes in the proportion that the direct process costs on each side of the cut-off point bear to the total direct process costs.

(iii) The third step is to take the total profit from the cement producing operation and reduce it by the profit attributable to indirect costs which do not benefit the entire operation. The remaining or "net" profit is allocated to pre and post kiln feed processes in the proportion that the direct process costs on each side of the cut-off point bear to the total direct process costs.

(iv) The taxpayer's "gross income from mining" is the sum of the costs and profits allocated to pre-kiln feed processes pursuant to the above three steps.

A simplified statement of the Regulation 118 computation has also been made by the *Whitehall*[91] court and this Court.[92] As stated by this Court, the formula may be expressed as:[93]

$$\frac{\text{"mining" costs}}{\text{total costs of product sold}} \times \text{sale price of product sold} = \text{gross income from mining}$$

The Government's case is based on its interpretation of this simplified statement of the computation. Brief-

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[91]*Whitehall Cement Mfg. Co. v. United States,* 369 F.2d 468 (3d Cir. 1966).

[92]See *Riddell v. California Portland Cement Co.,* 330 F.2d 16 (9th Cir. 1964).

[93]330 F.2d at 17.

ly, the Government's argument is (i) all costs must be expressly included in the depletion computation,[94] (ii) "no part of an integrated producer's costs (other than direct mining process costs) may be allocated to mining unless there is a discernible, demonstrable benefit to mining and the crude mineral product thereof,"[95] and (iii) any cost not "discernably" and "demonstrably" benefiting mining must automatically be placed in the denominator of the simplified computation.[96]

We submit that this is an erroneous interpretation of a formula which itself was intended merely to summarize and simplify the Regulation 118 computation.

(a) The Government's statement that all costs must be expressly included in the simplified depletion computation is misleading and, with respect to certain costs, incorrect. As stated in *Standard Lime*,[97] allocable indirect costs are allocated in the computation on the basis of direct process costs. Accordingly, if direct pre-kiln feed process costs are $10 and direct post-kiln feed process costs are $20, the pre-kiln feed to total process cost ratio is 1:3. If allocable indirect costs are then allocated to both sides of the cut-off point in proportion to the direct process costs, the depletion ratio remains 1:3. Obviously, therefore, it was not error for the District Court to hold that allocable indirect costs could either be included or excluded from the ratio computation[98]—the result remains the same either way. In addition, the preceding analysis has shown that incremental costs and revenues attributable

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[94]App. Br. 22.
[95]*Id.* at 25.
[96]*Id.* at 23.
[97]329 F.2d at 945.
[98]See, e.g., No. 22398, I-R. 185 (Finding 22).

to products after the first marketable product are to be excluded from the depletion computation.[99]

(b) The Government's argument that all indirect costs are automatically included in the denominator of the simplified computation unless they "discernably" and "demonstrably" benefit mining has even less merit.

(i) The express language of Regulation 118 establishes a subtraction formula. Costs and profits are allocated to post-kiln feed *processes;* this amount is deducted from the price of the first marketable product, and the entire remainder constitutes "gross income from mining." Using the Government's argument in relation to the express language of Regulation 118, therefore, if a cost could not establish a "discernable, demonstrable benefit" to post kiln feed treatment processes, it must *remain* as a mining cost.[100]

(ii) The *Standard Lime* quotation[101] relied on by the Government to support its alleged "non-mining" presumption is out of context. As noted above, the court had previously made clear that the allocation inquiry was whether an indirect cost benefited the *entire* extraction-production operation.[102] In addition, the *Standard Lime* court

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[99]Pp. 30-35, *supra*. See also the *Standard Lime* treatment of sacking at 329 F.2d 948-49 and Pltf. Ex.1.

[100]The correct position is that there is no presumption of allocation to either side of the kiln feed cut-off point. Allocation must be determined by reference to (i) the nature of the cost, (ii) the particulars of the industry concerned, and (iii) the purpose of the depletion computation. See pp. 42-45, *infra*.

[101]App. Br. 24-25.

[102]". . . [T]he total indirect costs which are incurred for the benefit of the *entire* operation are determined. These indirect costs are allocated to the first part of taxpayer's operation in the proportion as this part's direct costs bear to the aggregate direct costs." 329 F.2d at 945. (original emphasis)

specifically rejected the Government's argument that the denominator of the computation formula was a catch-all for all "non-mining" costs and, instead, held that if a cost which was not directly attributable to the flow of treatment processes did not benefit the entire mining-manufacturing operation, then such cost and the profits attributable thereto should be excluded from the computation.[103]

(iii) The statute and Regulation 118 speak of a flow of *process* costs. The context of the statute shows that the reference to "processes" means "treatment processes."[104] The leading judicial authority, *Cannelton,* states that the purpose of the depletion computation is that "the miner-manufacturer . . . [shall not] enjoy, in addition to a depletion allowance on his minerals, a similar allowance on his *manufacturing costs*. . . ."[105] Similarly, the court in *United States v. Henderson Clay Products,* 324 F.2d 7 (5th Cir. 1963), described the Regulation 118 computation as "a means of disintegrating an integrated company back into separate mining and processing entities."[106]

(iv) For the above reasons, it appears that much of the confusion caused by the Government's interpretation of the simplified statement of the Regulation 118 formula could be eliminated if that formula were stated as follows:

$$\frac{\text{Mining costs}}{\text{Total mining and manufacturing costs}} \times \text{Gross income from first marketable product} = \text{Gross income from mining}$$

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[103]329 F.2d at 945, 948 n. 19; Pltf. Ex. 1.

[104]See n. 127. *infra.*

[105]364 U.S. at 88.

[106]324 F.2d at 15.

This would place the emphasis in allocating indirect costs where it belongs, i.e., on the disintegration of an integrated miner-manufacturer into separate mining and manufacturing entities.

2. The Purpose of the Regulation 118 Computation.

By their very nature, indirect costs are often difficult to allocate to a particular process. It would appear evident that any such allocation in the depletion computation should be made by express reference to the purpose of that computation.

The leading case with respect to the depletion base computation is *United States v. Cannelton Sewer Pipe Co.*, 364 U.S. 76 (1960). There, the taxpayer extracted fire clay and shale from an underground mine, and then manufactured the minerals into vitrified sewer pipe and related products. The taxpayer contended that its depletion base should be the sales revenue from its manufactured end products. The Government argued that the depletion base should be the price at which nonintegrated miners sold the same crude mineral as that extracted by the taxpayer. In resolving this question, the Supreme Court made a careful analysis of the intent of the depletion allowance, as follows:

> "We have concluded that, under the mandate of the statute, respondent's 'gross income from mining' under the findings here is *the value* of its raw fire clay and shale, after the application of the ordinary treatment processes normally applied by nonintegrated miners engaged in the recovery of those minerals. . . .[107]
>
> "The Shepherd Report . . . [recognized] that *processing beyond this point should not be included* in calculating 'gross income from the property'.

[107] 364 U.S. at 78.

. . . [T]he report also proposed that the depreciation [sic] base 'in the case of all other metals, coal and oil and gas,' [should be] *the competitive market receipts, or its equivalent, received from the sale of the crude products,* or concentrates on an f.o.b. mine, mill, or well basis. . . .[108]

"From this legislative history, we conclude that Congress intended to grant miners a depletion allowance based on *the constructive income from the raw mineral product,* if marketable in that form, and not on the value of the finished articles. . . .[109]

". . . [R]espondent says that the processes it uses are the ordinary ones applied in the industry. As to the miner-manufacturer, that is true. But they are not the 'ordinary' normal ones applied by *the nonintegrated miner. It was he whom Congress made the object of the allowance.* The fabrication processes used by respondent in manufacturing sewer pipe would not be employed by the run-of-the-mill miner—only an integrated miner-manufacturer would have occasion to use them. . . .[110]

"We believe that the Congress intended integrated mining-manufacturing operations to be treated as if the operator were selling the mineral mined to himself for fabrication. *It would, of course, be permissible for such an operator to calculate his 'gross income from mining' at the point where 'ordinary' miners—not integrated—disposed of their product.* . . ."[111] (emphasis added)

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[108] *Id.* at 82-83.
[109] *Id.* at 86.
[110] *Id.* at 87-88.
[111] *Id.* at 89.

The Supreme Court's reasoning makes it clear that the depletion computation of an integrated miner-manufacturer should produce the same depletion deduction as that of a nonintegrated miner, whose depletion base is the gross revenue from sales of the crude mineral product (as beneficiated by allowable processing treated as "mining").[112]

The same purpose was emphasized by the Treasury representative, testifying before the House Ways and Means Committee with respect to the Treasury proposal which resulted in enactment of the kiln feed cut-off point for cement producers:[113]

> "MR. LINDSAY. Let me say this generally about cutting back, taking a proportionate amount of the profit from the finished product.
>
> "Where there is a market for the raw mineral at the stage at which percentage depletion is going to be allowed, that probably is a fair measure of the proportionate profit attributable to that raw mineral, proportionate profit from the sale of the finished product.
>
> "Now, you could work back to that on a formula and it may be that you come out with the same

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[112]The Government makes the surprising statement that "the *Cannelton* and *Monolith* decisions had nothing whatever to do with how an integrated producer's constructive income from mining should be computed." App. Br. 30. Both of said cases involved integrated producers, and in *Cannelton* the court specifically stated that the depletion allowance is to be based on "the constructive income from the raw mineral product . . . ." 364 U.S. at 86. Clearly the depletion computation's purpose of giving an integrated producer the same depletion base as that of a nonintegrated miner does not change whether the Regulation 118 reference is to a representative market or field price based on actual mineral sales or to a constructive market price derived by working back from sales of a subsequent product.

[113]*Hearings Before the House Committee on Ways and Means on Mineral Treatment Processes for Percentage Depletion Purposes,* 86th Cong., 1st Sess. (March 5, 1959).

result as you would have if you looked at the quoted price for that raw material. *Ideally the two systems would come out with the same result.*

"I do not think they always will. There will be minor differences. . . .

"If a taxpayer does not sell the crude mineral, but processes it beyond the mining stage, the regulations provide that the market price of the gross income product must be determined by the use of appropriate methods *with the objective of determining as accurately as practicable the price at which such gross income product would be sold if such commercial sales existed.*"[114] (emphasis added)

3. California Portland's Selling Expenses Clearly Benefit and Are Attributable to Its Entire Mining-Manufacturing Operation.

During the years concerned, California Portland incurred certain selling expenses with respect to the products of its integrated mining and manufacturing processes. These consisted primarily of expenses of membership in various industry trade associations, and the salaries and other expenses of salesmen.[115] The District Court found that these expenses did not represent the cost of any process applied to California Portland's calcium carbonate rock, and that such expenses were necessary and of benefit to both California Portland's mineral product and to its manufactured prod-

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[114] *Id.* at 46-47, 49.

[115] No. 22398, I-R. 185 (Finding 22).

uct.[116] This finding is completely supported by the evidence.[117]

The Government makes no reference to the record in opposition to the District Court's finding.[118] Instead, it makes a theoretical argument which illustrates the fallacy of its position that there is a presumption respecting the allocation of indirect costs in the depletion computation. The Government cannot find a close relation of selling expenses to mining processes, and concludes from this that such expenses must therefore be automatically allocated to manufacturing. In fact, however, as found by the District Court, selling expenses "did not represent the cost of *any process* applied to plaintiff's calcium carbonate rock."[119] (emphasis added) Applying the Government's logic to the express language of Regulation 118, selling expenses do not represent manufacturing processes, and since only the costs of such processes (and the profits attributable thereto) are subtracted from the first marketable product price,[120] *all* selling expenses should be included in the depletion base.

The District Court's finding that selling expenses are necessary and of benefit to both the mineral product and the manufactured product is supported by common sense as well as by the evidence. Since the objective of the depletion computation is to construct the price at which a hypothetical nonintegrated producer would sell kiln feed, and since the method of construt-

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[116]*Ibid.*

[117]Pltf. Ex. 19, 116-17; Pltf. Ex. 20 B-C, 240-41, 358, 360, 370-72.

[118]See App. Br. 36-39.

[119]N. 115, *supra.*

[120]See quotation of the Regulation and discussion at pp. 37, 40, *supra.*

ing such price is to develop the costs which such non-integrated producer would incur, it is plain that some selling expenses should be included in the depletion base.[121]

The Government admits in this case that California Portland's general and administrative expenses benefit both the mineral product and the manufactured product, and may be allocated to each such product in the ratio of direct mining process costs to total direct mining and manufacturing process costs.[122] In contending that selling expenses are exclusively manufacturing costs, however, the Government ignores the close analogy of such expenses to general and administrative expenses, its own previous publications, and the pertinent authorities.

Although an integrated miner-manufacturer is entitled to a percentage depletion allowance on the *gross* income from its mineral product, that allowance is limited by 50% of the taxable income from such product.[123] In determining taxable income, all costs and expenses which generate the "gross income from mining" must be deducted from such gross income. In the case of an integrated miner-manufacturer, therefore, the "mining" cost allocation serves two purposes: it provides the basis by which "gross income from mining" is determined, and it also provides the costs which are deducted from such gross income to yield taxable income from "mining." In its own Regulations on the computation of taxable income from mining for percentage depletion purposes, the Government expressly requires that an integrated miner-manufacturer allocate

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[121]An apt discussion of this conclusion is made by the District Court in *Whitehall*, quoted at pp. 51-52, *infra*.

[122]See Def. Ex. A (e.g., pp. 1-2 of ex. A thereto).

[123]Int. Rev. Code of 1954, § 613(a).

a pro-rata portion of his first marketable product selling expenses to "mining costs," as follows:

> "The term 'taxable income from the property' . . . as used in section 613 . . . means 'gross income from the property' as defined in section 613(c) . . . less *allowable deductions . . . attributable to ordinary treatment processes.* . . . [i.e., "mining"] *These deductions include* administrative and financial overhead, operating expenses, *selling expenses,* depreciation, taxes, losses sustained, etc. . . . Expenditures which may be attributable to both the mineral property upon which depletion is claimed and other activities shall be fairly apportioned."[124] (emphasis added)

In *Island Creek Coal Co. v. Commissioner,* 382 F.2d 35 (4th Cir. 1967), the court discussed the 50% of taxable income limitation as follows:

> "The statute does not explicitly define the term 'taxable income from the property.' There was no necessity of it, for the definition of 'gross income from property' in terms of 'mining' and the included treatment processes make it perfectly clear that 'taxable income from the property' means taxable income from mining and the included treatment processes. *Taxable income from mining is computed by deducting from gross income from mining all of the mining expenses incurred in the production of that income.* An expense incurred to produce income which is not income from mining, is not an expense of mining."[125] (emphasis added)

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[124]Reg. § 1.613-4.

[125]382 F.2d at 37.

Since the same costs which are included in "gross income from mining" are deducted in determining "taxable income from mining," it is obvious that if selling expenses are deductible in determining such taxable income, they must already have been part of "gross income from mining" to begin with. This has also been recognized by the Government in an express ruling that a nonintegrated producer may include selling expenses in his depletion base. Thus, in *Rev. Rul.* 60-98, 1960-1 C.B. 252, the summary of the Ruling states:

> "Where a mine operator sells his product through a *del credere* sales agent, the full sales price, unreduced by the sales commission, is the 'gross income from the property' for purposes of percentage depletion under Section 613(c) of the Internal Revenue Code of 1954."

Apart from a single trial court decision in Alabama,[126] the Government has not cited any case which upholds its present position that selling expenses are exclusively manufacturing costs.[127] The Government's theory appears to have arisen for the first time in

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[126] *United States Pipe & Foundry Co. v. Patterson,* 203 F. Supp. 335 (N.D. Ala. 1962).

[127] The Government does seek support (App. Br. 38-39) from the following quotation from *Standard Lime:*

> "The language of subparagraph (F) of subsection 613(c)(4) . . . specifically includes all processes up to kiln feed, 'but not including any subsequent processes.' We interpret this as excluding any subsequent manufacturing or *marketing processes.*" 329 F.2d at 946. (emphasis added)

We believe that the court's reference to "marketing processes" cannot be extended to selling expenses for the following reasons:

(i) *Standard Lime* did not involve selling expenses (329 F.2d at 942), and the above *dictum* was made in response to the taxpayer's contention that the issue was merely one of proper accounting treatment. (329 F.2d at 945-46).

(This footnote is continued on the next page)

1964 in *North Carolina Granite Corp., supra.* In rejecting this departure from the Government's published requirements and position, the court stated as follows:[128]

> "It is apparent that . . . [the Government's] argument rests in large measure upon its conclusions that the high price received by petitioner for poultry grit is chiefly attributable to *'nonmining processing'* in the form of advertising, goodwill, trademark, and *selling expenditures,* and that, absent such 'processing,' bulk poultry grit would command a price no higher than crushed granite sold for use as road material. . . .
>
> "As far as we are aware, this is the first case in which respondent has ever argued for such a result. *Reasonable selling expenses are normally considered as costs of mining, not as processing in addition to mining.* See section 1.613-4, Income Tax Regs." (emphasis added)

(ii) The commonly understood meaning of the term "process" in industry does not include selling expenses. Thus, Webster states that the term "process" means:

> "To subject to some special process or treatment . . . To subject (esp. raw material) to a process of manufacture, development, preparation for market, etc.; to convert into marketable form, as livestock by slaughtering, grain by milling, cotton by spinning, milk by pasteurizing, fruits and vegetables by sorting and repacking . . . ." WEBSTER'S NEW INTERNATIONAL DICTIONARY 1972 (2d ed. 1955).

(iii) The statute itself makes clear that the term "process" therein conforms to the above dictionary meaning. As shown by the quotation of subsection 613(c) at p. 36, *supra,* paragraph (2) of said subsection refers to the "treatment processes" described in pagagraph (4). Paragraph (4) is entitled "TREATMENT PROCESSES CONSIDERED AS MINING," and the introduction to that paragraph refers to "The following treatment processes . . . ." Accordingly, it is clear that the reference to "processes" in the kiln feed cut-off established in subparagraph (4)(F) means "treatment processes."

[128]43 T.C. at 158, 159, n. 13.

Similarly, in *United Salt, supra,* the court stated:[129]

> "To determine the . . . [taxpayer's] 'taxable income from the property' it is evident that '*gross income from the property*' *must be reduced only by those expenditures which are attributable to the mining stage,* and that some allocation must be made of petitioner's *general, administrative, and selling expenses which apply to both the mining and nonmining stages.* Respondent's regulations recognize the need for this allocation and provide that the allocation should be a fair one." (emphasis added)

One of the two cases on which the Government places its primary reliance in the present action is *Whitehall Cement Mfg. Co. v. United States,* 237 F. Supp. 838 (E.D. Pa. 1965), *affirmed* 369 F.2d 468 (3d Cir. 1966). (The other case is *Standard Lime,* which did not involve selling expenses). In *Whitehall,* the Government's present position on selling expenses was expressly rejected by the District Court in the following statement:[130]

> "*There can be no 'gross income from mining' if there is no sale of the product and there can be few sales without selling expenses.* The government does not appear to contend that plaintiff's selling expenses are unusual in the cement industry or that they would not be incurred by a non-integrated miner of cement. *Moreover, the government concedes that plaintiff's administrative expenses such as office salaries and expenses are incurred for the benefit of both plaintiff's mining*

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[129]40 T.C. at 359.

[130]237 F. Supp. at 843-44.

> *and manufacturing operations* and, that accordingly, these administrative expenses can be allocated between the mining and manufacturing phases of operations in the proportion that the cost of the mining processes before and after the kiln feed point bear to the total direct processing costs. *There appears to be no substantial reason why the two types of expenses should be accorded different treatments.* Accordingly, selling expenses like administrative expenses will be apportioned between mining and manufacturing costs in the proportion that the direct processing costs up to the kiln feed stage bear to the direct processing costs after the kiln feed stage. United Salt Corp., 40 T.C. 359 (1963); North Carolina Granite Corp., 43 T.C. 149 (1964), n. 13." (emphasis added)

The Government did not appeal from this portion of the *Whitehall* trial decision.

The same result was also reached in *Ideal Cement Co. v. United States,* 263 F. Supp. 594 (D.C. Colo. 1966) (appeal to 10th Cir. pending).[131]

Apart from its theory that there should be a presumption in favor of the denominator of the Regulation 118 ratio, the major argument of the Government on selling expenses is that an integrated miner-manufacturer of cement does not incur selling expenses with respect to kiln feed *per se,* because such expenses are incurred only in selling the first marketable product, bulk cement.[132] This obviously negates the entire principle of Regulation 118 and Section 613(c)(4)

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[131]263 F. Supp at 600-01 (Finding 54 and Conclusion 9).

[132]App. Br. 37.

(F). *Income* is not received with respect to kiln feed, because no one buys kiln feed. Such income must be constructed on a hypothetical basis, by working back from the sales which actually do occur. Similarly, the *expenses* of a nonintegrated producer must also be constructed on a hypothetical basis, by working back from actual sales.

A final contention of the Government is that there is no basis upon which to determine the proper allocation of selling expenses, if in fact such expenses are allocable.[133] This is so spurious that it merits comment only to avoid misleading this Court. All the cases hold that if an item is an indirect, nonprocess expense which benefits the entire mining-manufacturing operation, the basis of allocation shall be in accordance with the ratio of direct mining process costs to total direct mining and manufacturing process costs.[134] This allocation principle is recognized by the Government in this very case by its treatment of general and administrative expenses.[135]

Both Regulation 118 and *Cannelton* make it clear that the starting point for the depletion computation is the full price of the first marketable product. Rev. Rul. 60-98, *supra,* adopts this principle with respect to selling expenses and holds that the sales price of such

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[133]*Id.* at 38.

[134]E.g., *Whitehall, supra,* 237 F. Supp. at 843-44; *Standard Lime, supra,* 329 F.2d at 945:

> ". . . [I]ndirect costs which are incurred for the benefit of the entire operation are . . . . allocated to the first part of taxpayer's operation in the proportion as this part's direct costs bear to the aggregate direct costs."

The Government's own analysis of the depletion computation describes "Step Two" as follows:

> "Allocate Indirect Costs Shown on Cost Classification Sheet between Mining and Nonmining in Proportion to Direct Costs of Each" Def. Ex. A (ex. A thereto, p. 2).

[135]See n. 122, *supra.*

first marketable product is not to be reduced by such expenses. As shown by the table in Appendix B, however, the Government's position with respect to selling expenses provides a smaller depletion allowance than a computation which does reduce the sale price of the first marketable product by all selling expenses.

For the above reasons, we respectfully submit that the Government's position on selling expenses is completely unjustified.

4. California Portland's Alternative Contentions With Respect to Loading and Shipping Costs, and Sacking Costs.

As shown in Plaintiff's Exhibit 5, California Portland incurred expenses of $193,213 at its Colton plant in the representative year 1957 with respect to "loading and shipping applicable to calcined products (bulk equivalent)." The District Court treated this item as exclusively a manufacturing cost,[136] in accordance with the decision of the 1951-52 Case.[137] As previously indicated, California Portland believes that the seven years of litigation in the 1951-52 Case of the same issues here involved should bring an end to this controversy. Accordingly, California Portland is willing to rest on the computation established in that decision, even though there is authority which would treat the substantial item of loading and shipping costs on a basis more favorable than that of the 1951-52 Case and the decision of the District Court. We have cross-appealed on this point only for protective purposes, and seek to raise the alternative contentions set forth below in this section only in the event this Court desires to

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[136]No. 22398, I-R. 213.

[137]No. 18506, R. 25; Pltf. Ex. 9.

reopen and revise the computation of the 1951-52 Case and of the District Court.

The discussion in the previous section with respect to selling expenses appears pertinent to loading and shipping costs, and is incorporated in this section by reference. Loading and shipping is the type of expense referred to as a distribution expense in the case emphasized by the Government, *Standard Lime,*[138] and such a marketing expense appears in many ways analogous to a selling expense. It benefits California Portland's entire mining-manufacturing operation,[139] and is an expense which would be incurred by a nonintegrated miner who performed no manufacturing activities. In fact, in the usual case a nonintegrated miner selling a raw mineral product would have a much higher loading and shipping cost than a taxpayer selling at the end of an integrated mining-manufacturing operation, because of the decrease in bulk occurring when raw mineral is processed into a finished product.

The treatment of loading and shipping costs advocated in this alternative contention was adopted in the *Ideal Cement* decision,[140] and appears to conform to the *Cannelton* principle of equating integrated and nonintegrated miners. California Portland's alternative computations[141] follow the computation method of the 1951-52 Case and of the District Court,

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[138]329 F.2d at 948.

[139]Pltf. Ex. 20-C, 369-72; Cf., n. 117, *supra.*

[140]263 F. Supp. at 600-01 (Findings 52(b), 54; Conclusion 9).

[141]Pltf. Ex. 6 and 7; Pltf. Ex. 20-C, 401-03.

except that loading and shipping are allocated to the total mining-manufacturing process instead of being treated as exclusively attributable to manufacturing.[142]

Our position with respect to the incremental costs and revenues of sacking a portion of California Portland's cement is set forth at pp. 30-35, *supra*. In the event that this Court disagrees with the District Court and holds that sacked cement is not a product occurring subsequent to bulk cement, then we believe that the sacking costs and revenues should be allocated to both mining and manufacturing. The evidence establishes that sacking facilitated the sale of a portion of California Portland's cement,[143] and occurred after the processes which produced cement.[144] This alternative treatment of sacking was also adopted by the court in *Ideal Cement*.[145]

5. The Discounts Allowed by California Portland on Sales of Its Cement Were Clearly Cash Discounts and Not Trade Discounts.

The Pre-Trial Conference Order does not provide that California Portland's cash discount practices are an issue in this case.[146] The computation of the Government's principal witness, Mr. Lintz, treats cash dis-

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[142]As an alternative to the treatment of loading and shipping in *Ideal*, it would also be reasonable to follow the treatment of such cost in the Government's principal authority, *Standard Lime*. There, instead of including such cost in the computation as entirely a manufacturing cost, the court took the approach more favorable to the taxpayer of excluding from the computation both the costs and revenues attributable to loading and shipping. 329 F.2d at 948, n. 19.

[143]No. 22398, I-R. 98.

[144]N. 84, *supra*.

[145]263 F. Supp. 600-01 (Finding 51, Conclusion 7).

[146]No. 22398, I-R. 130, 132-33.

counts in a manner which achieves the same dollar result in California Portland's depletion base and depletion allowance as the method of the 1951-52 Case and of the Court below.[147] The Government's attorney expressly represented to the District Court that he would "stand on the Lintz affidavit and its computations," as explained in that affidavit.[148] For these reasons, we strongly objected to the Government's attempt to raise an issue with respect to California Portland's cash discount practices in its post-trial briefs,[149] and we renew that objection here. In addition, the Government has made no allegation that any authority has changed the law respecting cash discounts since the treatment of such item was established in the 1951-52 Case.[150] Since California Portland's practices and the other facts respecting its cash discounts were identical during the years in question with those found in the 1951-52 Case,[151] it is apparent that this point is an *a fortiori* case for application of collateral estoppel.[152] Even if the cash discounts point could be regarded as properly raised and open for relitigation of the 1951-52 result, however, the District Court's treatment of such item in accordance with the 1951-52 Case was clearly correct on the merits.

The District Court made the following finding of fact:[153]

> "13. Plaintiff offered to its customers, after sale, a discount of twenty cents per barrel of ce-

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[147]Def. Ex. A (E.g., ex. A thereto, p. 1).

[148]Tr. 44.

[149]Pltf. Op. Tr. Br. 71-72, 104.

[150]App. Br. 39-42.

[151]No. 22398, I-R. 185-86 (Finding 23).

[152]See pp. 8-9, 23-24, *supra*.

[153]No. 22398, I-R. 182.

> ment. . . . Said discounts were offered by plaintiff for the purpose of inducing prompt payment of plaintiff's invoices and not to induce sales of plaintiff's cement. . . . As practiced and applied during the taxable years . . . [1953-59], such discounts were cash discounts and not trade discounts."

This finding is clearly supported by the evidence.[154]

The distinction between a "cash discount" and a "trade discount" on a product sale is well stated by the Board of Tax Appeals in *American Cigar Co.*, 21 B.T.A. 464 (1930), *Acq.* XI-1 C.B. 1, as follows:[155]

> ". . . A trade discount is the difference between a seller's list prices for his goods and the amount at which he sells those goods to the trade. A cash discount has a very definite meaning also. It is a deduction from the price at which the goods are billed to the purchaser which the seller allows for payment within a certain stated time."

The Government's principal authority, *Standard Lime,* also correctly states the difference between the two types of discounts, as follows:[156]

> "Cash discounts are granted to purchasers in order to encourage prompt payment, thus producing a quicker flow of working capital. They differ from trade discounts in that the latter are granted at the option of the seller no matter when payment is made, depending on market conditions, while the former are availed of entirely at the option of the purchaser."

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[154]Pltf. Ex. 20 C-D, 232-37, 388; Pltf. Ex. 24, p. 4.

[155]21 B.T.A. at 499.

[156]329 F.2d at 947, n. 18.

The *Standard Lime* treatment of cash discounts[157] is in essence the same as the method of the District Court,[158] of the 1951-52 Case,[159] and of the Government's principal witness, Lintz.[160] It is also the same as that developed in *Riverside Cement Co. v. United States,* 58-2 USTC para. 9905 (S.D. Cal. 1958). In reaching this result, the *Standard Lime* court made the following statement, which is equally pertinent here:[161]

> "The Government contends that no part of this [cash discount] expense may be allocated to mining since '[n]o part of this expense was incurred at the end of mining when taxpayer theoretically sold the kiln feed to its manufacturing alter ego.' The Government's contention fails to envision the purpose for which these expense items serve. Taxpayer's experts testified that the function of a cash discount is to stimulate prompt payment in order to assure a quicker flow of working capital. It is a financial expense which is incurred for the benefit of both stages of the production process since it is obvious that working capital is needed for both the mining and manufacturing processes. Consequently, we must hold that cash discounts are an indirect expense which are incurred for the benefit of the entire operation and as such can be properly allocated in taxpayer's computation of gross income from the property at kiln feed."

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[157]329 F.2d at 947-48.

[158]No. 22398, I-R. 182, 186, 189 (Findings 13, 24; Conclusion 6); p. 39, *supra.*

[159]No. 18506, R. 12, 18, 20-21 (Finding 13, 20; Conclusion 7); Pltf. Ex. 9.

[160]N. 147, *supra.*

[161]N. 157, *supra.*

6. The Principal Authority Cited by the Government Does Not Support Its Position.

The Government alleges that the *Standard Lime* decision justifies a reopening of the 1951-52 Case computation and supports its present litigation theories.[162] Analysis of *Standard Lime* shows that this is simply not true.

(a) The Government contends that California Portland's costs of sacking a portion of its cement is a manufacturing cost and should be placed in the denominator of the depletion computation. We have shown that this treatment violates the express "first marketable product" requirement of Regulation 118, and results in two different constructive prices for the single, fungible product of kiln feed. The *Standard Lime* court regarded packing and loading costs of bulk cement to be analogous to the cost of sacking cement,[163] and had this to say about such costs:

> "If considered a direct non-mining expense, this would increase the denominator of the formula, *supra,* thus having a greater reducing effect in taxpayer's gross income from the property at kiln feed. *We cannot consider these items direct non-mining costs* since we have accepted taxpayer's expert's opinion concerning the point at which the mining-manufacturing processes cease."[164] (emphasis added)

The actual judgment computation of *Standard Lime*[165] eliminated $149,413.50 of "bag premium" from "gross income from cement," and under the heading "Bag Premium Cost Elimination," eliminated $146,180.55 of

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[162]App. Br. 24-25, 33, 38-39; Def. R. Tr. Br. 3.

[163]329 F.2d at 948-49.

[164]329 F.2d at 948, n. 19.

[165]Pltf. Ex. 1.

the cost of "containers" from the costs included in the Regulation 118 computation. *This elimination from the depletion computation of both the costs and revenues of sacking is exactly the procedure followed in the 1951-52 Case and by the District Court here.*

(b) Selling costs, which are one of the Government's major points of contention in the present case, were not involved in *Standard Lime*.[166]

(c) The Government alleges that loading and shipping costs are exclusively a manufacturing cost. As noted above, the *Standard Lime* court specifically rejected the Government's position on this point.

(d) As also discussed above, *Standard Lime* is direct authority against the Government's position on cash discounts, and completely supports the decision of the District Court on this point.

The Government's other main authority is *Whitehall Cement*. That case completely denies the Government's present position on selling expenses.[167] It is, however, the only case cited by the Government which supports its position on sacking costs. The only argument made by the *Whitehall* taxpayer on this point was that the incremental income received from the sale of cement in sacks was less than the cost of sacking. The Court held this argument invalid, because if *all* the costs and revenues attributable to sacked cement were considered, the sale of that product did not result in a loss.[168] In the present case the District Court specifically found as a fact that California Portland's first marketable product was bulk cement.[169] If the same finding had

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[166]See the statement of issues at 329 F.2d 942.

[167]Pp. 51-52, *supra*.

[168]369 F.2d at 473-74.

[169]No. 22398, I-R. 184-85 (Finding 21).

existed in *Whitehall,* and that court had been advised of the specific requirement in Regulation 118 that the taxpayer's first marketable product be used as the computation's starting point, we submit that *Whitehall* would have reached the same result as the great weight of authority discussed above.[170] This is particularly true since the *Whitehall* court was also not advised that the Government's position results in two different constructive values for the same fungible product—kiln feed.

For the foregoing reasons, we respectfully submit that every element of the District Court's depletion computation discussed in the sections above is fully supported by the 1951-52 Case, and by the overwhelming weight of all other pertinent authority.

7. California Portland's Handling Costs of Pre-kiln Additives Are Clearly Attributable to Its Mining Processes.

The remaining question in this case is minor, and concerns the $14,851 item in Plaintiff's Exhibit 5 for the representative year 1957 entitled "Costs of handling additives used prior to cutoff point." On this point, the District Court made the following finding of fact:[171]

> "14. The mineral materials iron ore and quartzite were added by plaintiff to its calcium carbonate rock in the production of its cement clinker and finished cement. Said minerals were added in the raw grinding stage prior to the introduction of the raw mix into the kiln, and such process was an essential step in the production of cement clinker and finished cement from plaintiff's cal-

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[170]Pp. 30-35, *supra.*

[171]No. 22398, I-R, 182-83.

> cium carbonate rock. Subsequent to acquisition by plaintiff but prior to actual admixture with plaintiff's calcium carbonate rock, said mineral materials were stored on plaintiff's premises and then moved to the point of admixture. Such storage and handling was a necessary part of the process of mixing said mineral materials with plaintiff's calcium carbonate rock prior to introduction into the kiln, and the cost of such storage and handling should be treated as a mining cost under the formula described in paragraph 18 of these Findings of Fact."

The Government does not dispute this finding, except for the conclusion that the costs of storing and handling pre-kiln additives is a mining cost.[172]

California Portland conceded at the trial that it was not entitled to depletion on the costs of acquiring the minerals used as additives to its in-process calcium carbonate rock prior to introduction of the kiln feed into the kiln. Accordingly, it asked the District Court to exclude from its depletion base the total acquisition cost of such additives up to the time it received delivery thereof at its cement plant. The Government admitted that the costs of blending or physically mixing such additives with California Portland's in-process calcium carbonate rock prior to the kiln feed stage was a "mining" cost.[173] The only controversy concerned the proper depletion treatment of the costs of handling these additives between the time they were delivered to California Portland's cement plant and the time they were physically mixed with its in-process

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[172]App. Br. 7-8.

[173]Tr. 19-20. See also, *Riddell v. California Portland Cement Co., supra,* 330 F.2d at 18.

calcium carbonate rock.[174] Such handling costs consisted primarily of storage until the additives were needed for use, and of physically moving the additives from the place of receipt at California Portland's plant to the place in said plant of blending and mixing with the in-process calcium carbonate rock.[175]

Subparagraph (F) of Section 613(c)(4) provides that California Portland is entitled to depletion on:

> ". . . all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process."

Paragraph (5) of Section 613(c) provides:

> ". . . Unless such processes are otherwise provided for in paragraph (4) (*or are necessary or incidental to processes so provided for*), the following treatment processes shall not be considered as mining'. . . ." (emphasis added)

Prior to the adoption by Congress of the kiln feed cutoff point, the Government took the following position in its *Rev. Rul. 290*:[176]

> "It is the position of the Internal Revenue Service that calcium carbonates and shale, mined for use in the cement industry, are not customarily

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[174]Tr. 19-20; Pltf. Ex. 20-B 210, 212.

[175]*Ibid.*

[176]1953-2 C.B. 41. This ruling, which primarily established a cutoff point for cement manufacturers after the raw grinding stage and prior to the kiln feed stage, was revoked after *Cannelton*. See *Rev. Rul.* 61-17, 1961-1 C.B. 8. A change in the cutoff point between "mining" and "manufacturing" does not affect the question of additives introduced at a point which all agree is "mining." The continued validity of the principle of *Rev. Rul.* 290 with respect to additives was expressly recognized by this Court on the second appeal of the 1951-52 Case. See p. 65, *infra*.

> sold in the form of the crude mineral product, and that, therefore, under . . . [Regulation 118], crushing and grinding are considered 'ordinary treatment processes' in the computation of gross income from the property for percentage depletion purposes. Blending with other material after crushing and grinding, such as that occurring at the kiln feed bins, is excluded from 'ordinary treatment processes,' but *where mixing of the calcium carbonates and shale occurs before crushing and grinding, it will be considered as incidental to such processes.*
>
> *"The gross income for percentage depletion purposes must of course be computed separately with respect to each component mineral, notwithstanding any such mixing. . . ."* (emphasis added)

In the second appeal of the 1951-52 Case, this Court commented on *Rev. Rul.* 290 and the subsequent adoption by Congress of the kiln feed cutoff point as follows:[177]

> "We believe that by the enactment of the amendment in question Congress intended only to move the cutoff point from the crushing and grinding stage to the pre-kiln stage, but not to alter the revenue ruling with respect to separate computation of depletion of component minerals. To hold otherwise would be to allow a double deduction on the iron ore extracted by the taxpayer. . . . Surely Congress did not mean to grant the additional relief of allowing depletion upon minerals already depleted. . . ."

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[177] *Riddell v. California Portland Cement Co.*, 330 F.2d 16, 18-19 (9th Cir. 1964).

The above authorities establish that activities "necessary or incidental" to "ordinary treatment processes" are attributable to "mining," but that both the seller and the purchaser of a mineral are not each entitled to the same depletion deduction with respect to that mineral.

In the present case, it is clear that the miner of the additives acquired by California Portland is entitled to depletion on the sales price or value of such additives, and that the District Court's computation has entirely eliminated such price or value from California Portland's depletion base. At the same time (as testified by the Government's witnesses,[178] as evidenced by the small amount concerned, and as specifically found by the District Court), the use of these pre-kiln additives is obviously only most incidental to California Portland's mining processes.[179] Accordingly, on the rationale and results of the above authorities, it is clear that the "handling costs of additives" here concerned are much more analogous to the blending activities, which the Government admits are part of California Portland's depletion base, than to the taking of a double depletion deduction with respect to the same mineral which this Court forbids.

The Government's principal argument against the above conclusion appears to be that said handling and storage costs are costs of "processes" applied to the additives themselves, rather than to California Portland's calicum carbonate rock.[180] It is clear, however, that the only "process" here concerned is that of

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[178]Pltf. Ex. 19, 29, 62, 112-15.

[179]*Accord, Ideal Cement, supra,* 263 F. Supp. at 601 (Finding 61).

[180]App. Br. 26-27.

blending the pre-kiln additives with the calcium carbonate rock—a process which the Government admits is "mining." Certainly the cost of placing the additives in a position so that they may be blended is necessary and incidental to the blending process.

Conclusion.

The District Court's depletion computation is supported, pursuant to the principles of collateral estoppel and *stare decisis,* by exactly the same result on the same facts in the 1951-52 Case. In addition, the District Court's decision is also supported in all respects by the overwhelming weight of the other pertinent authorities. Accordingly, we respectfully request that the judgment below be affirmed.

Respectfully submitted,

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April, 1968

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

STUART T. PEELER

APPENDIX A.

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *

* * * *

(26 U.S.C.A. § 611, West's 1967 ed.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). * * *

(b) *Percentage depletion rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

* * * *

(7) 15 percent—all other minerals (including, but not limited to * * * calcium carbonates * * *)

* * * *

(c) *Definition of gross income from property.*—For purposes of this section—

(1) *Gross income from the property.*—The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) *Mining.*—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto) * * *.[1]

* * * *

(4) *Treatment processes considered as mining.*—The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

* * * *

(F) in the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

* * * *

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[1]The quotation of § 613(c)(2) in the Appendix to the Government's brief appears erroneous. Such quotation does not reflect the 1960 amendment to said § 613(c)(2), which is applicable here.

(26 U.S.C.A. § 614, West's 1967 ed.)

Public Debt and Tax Rate Extension Act of 1960, P.L. 86-564, 74 Stat. 290:

SEC. 302. DEPLETION RATE FOR CERTAIN CLAYS; TREATMENT PROCESSES CONSIDERED AS MINING FOR COMPUTING PERCENTAGE DEPLETION IN THE CASE OF MINERALS AND ORES.

* * * *

(b) *Treatment Processes Considered as Mining.* —Subsection (c) of section 613 of the Internal Revenue Code of 1954 (relating to the definition of gross income from property) is amended as follows:

(1) By amending paragraph (2) to read as follows:

"(2) *Mining.*—The term 'mining' includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto) * * *."

(2) By striking out paragraph (4) and inserting in lieu thereof the following new paragraphs:

"(4) *Treatment processes considered as mining.*—The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

* * * *

"(F) in the case of calcium carbonates and other minerals when used in making cement —all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

* * * *"

(c) *Effective Date.*—The amendments made by subsections (a) and (b) shall be applicable only with respect to taxable years beginning after December 31, 1960.

Act of September 14, 1960, P.L. 86-781, 74 Stat. 1017:

SEC. 4. Subsection (c) of section 302 of the Public Debt and Tax Rate Extension Act of 1960 (Public Law 86-564; 74 Stat. 293) is amended to read as follows:

"(c) *Effective Date.*—

"(1) *In general.*—Except as provided in paragraph (2), the amendments made by subsections (a) and (b) shall be applicable only with respect to taxable years beginning after December 31, 1960.

"(2) *Calcium carbonates, etc.*—

"(A) *Election for past years.*—In the case of calcium carbonates or other minerals when used in making cement, if an election is made by the taxpayer under subparagraph (c)—

"(i) the amendments made by subsection (b) shall apply to taxable years with respect to which such election is effective, and

"(ii) provisions having the same effect as the amendments made by subsection (b) shall be deemed to be included in the Internal Reve-

nue Code of 1939 and shall apply to taxable years with respect to which such election is effective in lieu of the corresponding provisions of such Code.

"(B) *Years to which applicable.*—An election made under subparagraph (C) to have the provisions of this paragraph apply shall be effective for all taxable years beginning before January 1, 1961, in respect of which—

"(i) the assessment of a deficiency,

"(ii) the refund or credit of an overpayment, or

"(iii) the commencement of a suit for recovery of a refund under Section 7405 of the Internal Revenue Code of 1954,

is not prevented on the date of the enactment of this paragraph by the operation of any law or rule of law. Such election shall also be effective for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before the date of the enactment of this paragraph.

* * * *"

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.9003-2

Effect of election.

(a) *In general.* If a taxpayer makes the election described in paragraph (b) of Section 1.9003-1, he shall be deemed to have consented to the application of section 302(b) of the Act with respect to all taxable years to which the election applies. Thus, subparagraph (F) of section 613(c)(4) of the Internal

Revenue Code of 1954 as amended must be applied in determining gross income from mining for the taxable years to which the election applies (including years subject to the Internal Revenue Code of 1939) whether or not the taxpayer is litigating the issue. Further, the election shall apply to all calcium carbonates or other minerals mined and used by the taxpayer in making cement.

* * * *

(26 C.F.R. Sec. 1.9003-2.)

Treasury Regulations 118 (1939 Code):

SEC. 39.23(m)-1. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*

* * * *

(e) As used in sections 114(b)(3) and 114 (b)(4)(A) and sections 39.23(m)-1 to 39.23(m)-19, inclusive, the term "gross income from the property" means the following:

* * * *

(2) In the case of a crude mineral product other than oil and gas, "gross income from the property," as used in section 114(b)(4)(A), means the gross income from mining. The term "mining" as used herein includes not only the extraction of ores or minerals from the ground but also the ordinary treatment processes which are normally applied by the mine owners or operators to the crude mineral product after extraction in order to obtain the commercially marketable mineral product or products.

* * * *

(3) If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but, if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product (other than transportation treated, for the taxable year, as mining). If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportaion treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

* * * *

APPENDIX B.

	Examples					
	1	2	3	4	5	6
Treatment of Selling Expense as Exclusively Attributable to Manufacturing.						
Selling price	$100	$100	$100	$100	$100	$100
Pre cut-off cost	10	20	30	40	50	60
Post cut-off cost						
Selling expense	10	15	20	15	10	5
Other	60	50	40	30	20	10
Total post cut-off cost	70	65	60	45	30	15
Total cost	80	85	90	85	80	75
Cut-off ratio	10/80	20/85	30/90	40/85	50/80	60/
Gross income from mining	$12.50	$23.53	$33.33	$47.06	$62.50	$80
Selling Price of First Marketable Product Reduced by Selling Expenses.						
Selling Price	$100	$100	$100	$100	$100	$100
Less selling expense	(10)	(15)	(20)	(15)	(10)	(5
Selling price as adjusted	90	85	80	85	90	95
Pre cut-off cost	10	20	30	40	50	60
Post cut-off cost	60	50	40	30	20	10
Total cost	70	70	70	70	70	70
Cut-off ratio	10/70	20/70	30/70	40/70	50/70	60/
Gross income from mining	$12.86	$24.29	$34.29	$48.57	$64.29	$81